

The Financing of the Hudson Yards Development Project

The Committee on New York City Affairs

The New York City Affairs Committee (the “Committee”) of the New York City Bar Association (the “Association”) conducted an extensive review of the financing by New York City (“City”) of the development of the Hudson Rail Yards, a 45-block area on the far west side of Manhattan adjacent to the mid-Manhattan central business district. The Committee focused on the historical and fiscal ramifications of the financing and its incentive structures which can be fairly characterized as creative and unusual. The Association’s review is intended to provoke discussion about the means of financing infrastructure in New York City.

I. INTRODUCTION

On December 7, 2006, the Hudson Yards Infrastructure Corporation (“HYIC”), a special purpose local development corporation created by the City as an instrumentality of the City, successfully sold \$2 billion of revenue bonds to provide initial financing for the City’s Hudson Yards Development Project (the “Hudson Yards Project”).¹ As described on the website

1. The HYIC is able to issue its bonds on a tax-exempt basis under IRS Revenue Ruling 63-20 and Revenue Procedure 82-26, governing obligations issued by a non-profit corporation formed under the general non-profit corporation law of a state for the purpose of stimulating industrial development within a political subdivision of the state.

of the Hudson Yards Development Corporation (“HYDC”),² also a local development corporation created by the City to manage the Hudson Yards Project, Hudson Yards is the area of Manhattan generally bounded by West 43rd Street on the north, Seventh and Eighth Avenues on the east, West 29th and 30th Streets on the south, and Twelfth Avenue on the west. The City, the Metropolitan Transportation Authority (“MTA”), and the State of New York (“State”) have collaborated on extraordinary planning initiatives over the past 5 years intended to create a development program intended to transform the Hudson Yards area into a vibrant, pedestrian-friendly, transit-oriented mixed-use district.

Key components of the Hudson Yards Project are:

- Rezoning of the area from manufacturing to commercial and residential, which was adopted by the City in January 2005. As rezoned, Hudson Yards now has capacity for approximately 25 million square feet of new office development, 14 million square feet of housing, including in excess of 4,000 affordable units, 1.3 million square feet of retail, and 2.3 million square feet of hotel space.
- The extension of the No. 7 subway line from its current terminus at Times Square to a new terminal station at 34th Street and 11th Avenue (the “Subway Extension”).
- Mixed-use development over the eastern section of the MTA West Side Rail Yards.
- A joint planning and development effort, together with the MTA and the City Council, for the western section of the MTA West Side Rail Yards.
- Creation of new parks and public open space throughout the Hudson Yards area.

The Hudson Yards Project is intended to provide infrastructure that facilitates the creation of a medium to high density, mixed-use commercial and residential district containing new medium to large scale commercial, residential, hotel and retail developments and new parks and public open spaces in a significant portion of the Hudson Yards Project area.

The Hudson Yards Project, if completed as planned, would constitute the fourth largest central business district in the United States, after

2. <http://www.lyde.org>.

Midtown Manhattan, the Chicago Loop, and the Downtown Manhattan Financial District. The development will feature a new nine-block boulevard and park akin to Park Avenue and currently referred to as "10½ Avenue."

The Hudson Yards Project, breathtaking in scale and imagination, represents a spectacular episode of urban planning and government leadership in partial response to the projected increase of one million in the City's population by the year 2030 and in recognition that the primary business district growth area in Manhattan is the far west side. The rezoning of the 45-block Hudson Yards Project area, part of the City's sustained rezoning effort, the largest in its history, was a triumphant political and legal accomplishment that took years of planning, outreach, and negotiation. While many consider expansion of the mid-Manhattan central business district to the far west side to be inexorable, it could not occur without the rezoning and planning that the City has completed. The New York City Bar Association salutes the City's leadership for this accomplishment, which should be considered in the context of the anti-development sentiment on the far west side exhibited in the demise of the Westway Interstate Highway development project in the 1980s.

The HYIC December 2006 financing was the first tranche of an authorized \$3.5 billion financing, of which \$2.1 billion of the proceeds is intended to pay for the design and construction of the western extension of the No. 7 subway line, first from Times Square to West 41st Street and Eleventh Avenue and then to West 34th Street and Eleventh Avenue.³ Based on the \$2.1 billion cost estimate, the City intends to pay 100 percent of the cost of the Subway Extension. The No. 7 line is controlled and operated by the MTA. Under normal circumstances, capital projects of the MTA in the City would be funded 80 percent by the federal government, 15 percent by the State, and 5 percent by the City. Because the MTA and the State refused to consider the extension of the No. 7 line to be a capital priority, the City made the decision to pay for the Subway Extension itself, at least to the extent of the 2006 cost estimate. (It is not clear, however, who would pay for any cost increases if the \$2.1 billion cost estimate for the Subway Extension proves to be insufficient. The City has said that in that event, it will negotiate with the MTA but the MTA has said it will not pay any of the costs of the Subway Extension. It is also uncertain who will pay for a contemplated station at 41st Street and Elev-

3. See, e.g., Press Release PR-341-06, Sept. 27, 2006, available at <http://www.hydc.org> (detailing Mayor Bloomberg, Governor Pataki, and MTA Chairman Kalikow's announcement regarding the rail yard development and No. 7 subway line extension).

enth Avenue, which is not part of the cost estimate and is not included in the initial expansion.)

The City's decision to pay 100 percent of the 2006 cost estimate of the Subway Extension reflects its importance to the Hudson Yards Project. Much as the construction of the City subway system unified the City and allowed it to develop and grow in an orderly fashion, the City believes that subway investment will spur development in the Hudson Yards Project area so as to generate revenues sufficient to pay for the Subway Extension, rendering it a self-financing project.⁴ Eventually, it is planned and hoped that the extended No. 7 line will link with Penn Station, moved and reborn as the Moynihan Station Complex at 34th Street and Eighth Avenue, a State project to be financed, in part, by the Empire State Development Corporation that has not yet received the necessary governmental approvals.⁵

The decision to pay 100 percent of the 2006 cost estimate of the Subway Extension and also to pay for the necessary infrastructure to create parks and open spaces in the commercial, residential, hotel and retail development areas required the City to select a method of financing to generate proceeds sufficient to complete the Hudson Yards Project. The City decided to bypass the normal capital budget processes that must be completed to issue General Obligation Bonds backed by the full faith and credit of the City (essentially City guaranteed debt). The City devised an innovative financing scheme whereby it would create an entity—HYIC—to issue revenue bonds backed by payments in lieu of real estate taxes (“PILOT”) applicable to, and designed to incentivize new development in the Hudson Yards Project. The new development falling under this regime would not be subject to City real estate taxes for 19 years and the PILOT revenues would be dedicated to HYIC to pay the debt service.⁶ That decision and that financing scheme necessitated a series of consequential legal, political, and policy decisions that are laden with risk/reward calculations. These calculations define risks that the City has decided to undertake. Those risks are the subject of this Report.

4. See Charles V. Bagli, *West Side Plan is Risky Effort, Forecasters Say*, N.Y. TIMES, Dec. 21, 2004, at B1 (quoting Deputy Mayor Daniel L. Doctoroff's testimony to the City Council that “[w]e developed a creative financing plan that pays for itself with new revenues it will generate—not with capital budget money.”)

5. See generally <http://www.rpa.org/pdf/RPAMoynihanStation.pdf> (providing Regional Plan Association's November 2005 report on the Moynihan Station plan).

6. See, e.g., Charles V. Bagli, *Financing Plan to Rebuild Far West Side is Unveiled*, NY TIMES, Aug. 6, 2004, at B3.

II. THE FINANCING PLAN—CONTRACTUAL (AND MORAL?) OBLIGATION

As initially conceived, the Hudson Yards Project featured expansion of the Javits Convention Center (to be financed by a State authority) to be accompanied by construction of a new football stadium for the New York Jets at the Hudson Rail Yards (to be financed by City, State and private sources). This initial plan in large part was designed in support of the City's effort to attract the 2012 Olympics, with the proposed Jets stadium intended to be the Olympic stadium and also a plenary session adjunct of the Convention Center.⁷ The Subway Extension was central to the Olympic, stadium and Convention Center plans.

The initial plan also was designed to bypass lengthy and uncertain political approvals so as to avoid delay and enhance the Olympic bid. In effect, the Olympic bid and football stadium proposals put the elaborate far west side development plan on the back pages (sports) and not the front pages (politics). The Jets stadium proposal, however, generated well-financed controversy that was not anticipated, and the intricate stadium financing, which involved assets of the MTA, required approval of the Public Authorities Control Board ("PACB"), a joint State legislative/executive body. The PACB rejected the stadium, and the City did not win the right to host the 2012 Olympics. After those events, the white hot political controversy generated by the proposed stadium dissipated. But the City proceeded with the overall west side development, having largely avoided the necessity of various governmental reviews that normally serve as vehicles of political opposition. The City reached accommodation with the MTA on a land and air rights fair market valuation methodology for the Rail Yards and also reached agreement, theretofore eschewed, with the City Council with respect to the Hudson Yards Project financing plan.

The essence of the revenue bond financing plan for the HYIC is that developers of properties in the Hudson Yards Project area will make Payments in Lieu of [real estate] Taxes ("PILOTs") dedicated to the HYIC so that HYIC could pay the debt service (interest only for 40 years) on the HYIC bonds.⁸ The developers' obligation to pay PILOTs as opposed to real estate taxes is a result of a Uniform Tax Exemption Policy ("UTEP") adopted by the City's Industrial Development Agency ("IDA"). UTEP provides a "substantial discount" from property taxes for 19 years to developers of

7. See *id.* (describing the incorporation of the Jets/Olympic stadium into the Hudson Yards development plan).

8. See HYIC Official Statement at p. 15-16.

commercial properties in the Hudson Yards Project development area who enter into arrangements with the IDA under the IDA's economic development authority.⁹ The IDA is an affiliate of and is controlled by the City's Economic Development Corporation ("EDC"). The HYIC and the HYDC are also affiliates of EDC.

Under usual circumstances, developers who construct buildings or revenue generating facilities on government owned land in New York are exempt from real estate taxes but are required to pay PILOTs instead in an amount equivalent to the real estate tax. PILOTs are calculated and assessed in the same manner as are real estate taxes, and they are paid into the City's general fund.

The IDA has utilized PILOT diversion previously but never on the scale of the Hudson Yards Project. In a prototypical IDA transaction, the IDA acquires a manufacturing site with the proceeds of tax-free bonds issued by it. This transaction is done to provide less expensive tax-free financing to a job-creating entity that would enter into a lease-back agreement with the IDA for the factory. The rent that the manufacturer would pay would be equal to the debt service on the IDA bonds. On some occasions the PILOT (since the site would be on government-owned and, therefore, tax-exempt property) also would be applied to the debt service. This job creation/retention device is employed throughout the State as a means to offer private employers access to less expensive financing as an inducement to locate or stay in the State and create jobs in the State.¹⁰

Two very recent and precedent setting uses of this technique will be manifested in the development of the new baseball stadia for the Mets and the Yankees using tax-free debt issued by the IDA. The clubs will pay PILOTs to service the debt under agreements made pursuant to a special tax ruling of the U.S. Internal Revenue Service. While this financing technique for private baseball teams can be criticized as an inappropriate subsidy to the teams and an unnecessary diversion of PILOTs, the PILOTs are

9. *Id.*

10. A developer planning to build within the Hudson Yards district would have the option of entering a PILOT agreement with the New York City Industrial Development Agency ("IDA"). Under such an agreement, IDA would buy the land to be developed from the developer for a token amount, which would take the land off the property tax rolls, and the developer would then make PILOT payments to IDA for the term of the agreement. Generally, the developer would enter the PILOT agreement when making other financing arrangements. At the end of the term of the Agreement, the IDA would return the land to the developer for a token amount and the land would return to the City's property tax rolls. The IDA would establish a uniform PILOT payment schedule for Hudson Yards.

not discounted, and the financing is solely for the benefit of a single, job creating entity.¹¹ With particular respect to the Yankees transaction, the PILOTs are going to be generated by luxury suites and season ticket sales. In the previous two seasons the Yankees have had an average attendance of 4 million, and an attendance of less than 750,000 is all that is needed to generate the annual debt service revenues, so there is virtually no financing risk. Also, there is a guaranteed maximum price construction contract, so there is limited construction cost overrun risk. Finally, there is bond insurance, and the stadium will be built on City land which otherwise would not have produced real estate tax revenue. In the HYIC financing plan, on the other hand, PILOTs are to be diverted and discounted substantially across the board for the purpose of permitting revenue bond financing as opposed to general obligation financing,¹² and much of the land on which development may occur previously was subject to real estate taxation. Other instances where the City discounted real estate taxes for job retention purposes include agreements made in the 1990's with NBC and Prudential Securities. The Committee did not examine these transactions.

1. Capital Budget; General Obligation Debt

The alternative to use of the PILOT (and similar) revenues to create a revenue stream to service the HYIC bonds would have been to subject the development to real estate taxes and for the City to issue general obligation bonds pursuant to its regular capital budget processes. The building of a capital project on the scale of an extension of a subway line with associated amenities normally would be a function of the City capital budget assuming there would be room under the debt limit (See below).¹³ The City Independent Budget Office publishes a guide to the capital budget, which reads in pertinent part:

New York City has a Capital Budget, separate from its annual

11. The proposed Nets Arena in the proposed Atlantic Yards Development in Brooklyn also will employ IDA/PILOT financing.

12. Developers also will be excused from paying Mortgage Reporting Taxes. Instead they will make Payments in Lieu of Mortgage Reporting Taxes ("PILOMRT'S") to the HYIC.

13. See New York City Charter, Chapter 9 ("Capital Projects and Budget"), available at <http://www.nyc.gov/html/charter/downloads/pdf/citycharter2004.pdf>—As of the end of City Fiscal Year 2005, the City's total outstanding debt was \$78.2 billion, of which \$34.6 billion was General Obligation Debt. The balance was Authority debt including the Transitional Finance Authority which was employed as a borrowing vehicle when the City debt limit was constricted. (Source: Citizen's Budget Commission, September 2006).

operating (or expense) budget, which presents the funding plans for construction and repair projects; and purchases of land, buildings or equipment. Technically speaking, a “capital project” involves the construction, reconstruction, acquisition, or installation of a physical public improvement, with a value of \$35,000 or more and a “useful life” of at least five years. This may include everything from building bridges to building housing.¹⁴

The Guide adds further “The capital program is generally financed by borrowing money, usually through the sale of bonds. This differs from the City’s Expense Budget, which covers day-to-day operating expenditures and is financed by City taxes and other revenues along with state and federal aid.”¹⁵

The City capital budget has a vetting process, described in lay terms in the Guide, which is similar to the process whereby the City’s annual operating budget is enacted into law by the City Council. This process was sidestepped by the City’s decision to create HYIC and issue revenue bonds. In an October 20, 2004 letter, City Comptroller William C. Thompson, Jr. criticized Mayor Bloomberg for this decision:

You chose not to include this project [Hudson Yards] in the capital budget, avoiding City Council approval. In doing so, you removed the public’s only opportunity for meaningful and serious review of the merits of your plan against other priorities, such as the construction of new schools or senior centers...Indeed, if your plan for the West Side is worthy of our City’s investment, it should be included in our capital budget and subject to scrutiny beyond what is offered to date.¹⁶

In 2006, however, the Comptroller endorsed the HYIC financing plan, primarily as a result of an agreement between the City and HYIC and endorsed by the City Council with respect to interest support payments whereby the City Council would appropriate on annual basis funds that may be required to cover interest on the HYIC bonds. (See “Support and Development Agreement” below.)

14. Understanding New York City’s Budget: A Guide to the Capital Budget. (“Guide”) November, 2002, pp.2. Available at www.ibo.nyc.ny.us.

15. *Id.*

16. See, Testimony of James A. Parrott, PhD., Deputy Director and Chief Economist, Fiscal Policy Institute, Hearing before New York City Industrial Development Agency (“Proposal to Amend the Uniform Tax Exemption Policy for Hudson Yards Commercial Construction Projects”) New York City, August 3, 2006.

General obligation bonds are issued for capital budget purposes and are full faith and credit obligations of the City. A buyer of a general obligation City bond is assured of payment because it has first call on all of the City's revenues, most notably the real estate tax. Unlike the State, which cannot issue general obligation debt unless a specific bond issue (*e.g.*, a transportation bond issue) is approved by the voters in a general election, the City can issue general obligation debt up to its constitutional debt limit.

Article 8 of the State Constitution at Section 2 provides in pertinent part:

No indebtedness shall be contracted by any...city...unless such...city...shall have pledged its full faith and credit for the payment of the principal and the interest thereon.

Article 8, Section 4 of the State Constitution limits the amount of full faith and credit debt the City can issue. The City cannot issue debt in an amount in excess of its "general debt limit" of 10 percent of the average full value of taxable real estate in the City for the most recent 5 years. Currently, the City is under its general debt limit. According to the "Fiscal Year 2007 Annual Report of the Comptroller on Capital Debt and Obligations," the City had about \$13.7 billion of room in the Debt Limit when the HYIC bonds were sold. The general debt limit is dynamic; as the assessed value of the City's taxable real estate increases, so does its general debt limit and the dramatic and continuing rise in the values of New York City real estate in the last decade have raised the City's debt limit.¹⁷ The City could have issued full faith and credit City debt to finance the Hudson Yards Project but chose instead to create an entity, HYIC, to issue not-for-profit corporate debt backed by to-be generated revenues.

2. Support and Development Agreement

The use of revenue bond financing backed primarily by PILOTs carries risk because PILOTs will not be payable until the buildings against which real estate taxes would be assessed are actually built. Thus, even assuming development in the Hudson Yard Project area proceeds as anticipated, there is not expected to be a revenue stream sufficient to service the HYIC bonds until *at least* the Fiscal Year ending June 30, 2014.

Therefore, to create a mechanism to assure purchasers of the HYIC

17. The City had in excess of \$13.6 billion of additional room in its debt limit at the end of 2006.

bonds that the debt service would be paid during the period before the PILOT revenue stream began, or thereafter if the PILOT revenue stream were to be insufficient, the City entered into a contract with the HYIC: the Support and Development Agreement. Pursuant to the Support and Development Agreement, the City unconditionally agreed with HYIC to pay the interest on the HYIC revenue bonds to the extent revenues (mostly PILOTs) are insufficient to make the interest payments. The Support and Development Agreement extends for the life of the HYIC bonds. However, in any year that Hudson Yards Project revenues are insufficient to cover debt service on the HYIC bonds and the City is contractually obliged to pay interest support payments to the HYIC, the City Council will be asked to appropriate the required amounts. However, the City Council is not legally required to do so.

Proponents of the HYIC financing plan term the revenue bonds as “contract indebtedness.” But the City is only contractually obliged to the HYIC, a corporation it created, owns and controls. As set forth in the HYIC Official Statement dated December 7, 2006:

In resolutions adopted January 19, 2005 and October 11, 2006, the City Council recognized the importance to the City of the redevelopment of the [Hudson Yards] Project Area and supported an undertaking by the City, *subject to annual appropriation*, to make Interest Support Payments. (at p. 14, emphasis added)

*The Support and Development Agreement and the City’s obligation to make such payments do not constitute debt of the City ... The City is not legally required to make annual appropriation for such payments. The ability of the City to fulfill its obligations under the ... Agreement ... may depend on the financial condition of the City.*¹⁸

Pursuant to Resolution 760 and City Council Resolution 547 of the City Council, the HYIC also will receive the following projected revenues:

- Proceeds from the sale of certain transferable development rights which would in turn be sold by the HYIC to private developers;
- Payments from the City of revenues provided by residential real property taxes or other real property taxes generated within the Hudson Yards District not captured by other mechanisms (such as PILOTs);

18. See HYIC Official Statement, Dec. 7, 2006 (Emphasis added).

- Payments in Lieu of Sales Tax (“PILOTS”) on construction materials purchased by developers within the Hudson Yards District;
- Payments in lieu of the mortgage recording tax (“PILOMRT”) paid by developers within the Hudson Yards District; and
- Contributions by developers to a Hudson Yards district improvement fund (“DIF”) in order to obtain a floor area bonus pursuant to proposed amendments to the City’s zoning resolution.¹⁹

The City is contractually obliged to the HYIC, but the agreement of the City Council with respect to the HYIC bonds is only articulated in two resolutions. Neither the current City Council nor a future one is legally obliged to appropriate funds to pay interest on the HYIC bonds. And even if the current City Council had enacted a law requiring it to appropriate funds to pay debt service on the HYIC bonds, one legislature cannot bind the hands of another in the future.²⁰ Although the City Council is not legally obliged, one could say that by virtue of its 2005 and 2006 resolutions, the current Council is “morally obliged.”

3. Moral Obligation Debt

During the expansive period from 1959 to 1973, when Nelson Rockefeller was the governor of the State, to avoid the necessity of attaining voter approval for bond issues, which frequently were defeated, the State increased its reliance on borrowing by legislatively created State authorities, which have been described as public/private hybrids that can collect fees, issue debt and build things with little government interference.²¹ Certain authorities, such as the Triborough Bridge and Tunnel Authority, have defined and ample revenue streams, such as bridge and tunnel tolls, and are capable of supporting considerable debt. The Port Authority of New York and New Jersey and the City Water Authority are other examples of sound issuers of revenue-backed debt.

19. Developers would have the option, with respect to certain parcels, to build more than the base zoning would allow if they made a DIF payment.

20. See, *Moran v. Foster*, 45 N.Y.2d 287, 293 (1978) (“Unless specifically provided by statute or charter provisions, one county legislature may not bind the hands of its successors in areas relating to governmental matters (see *Murphy v Erie County*, 34 AD2d 295, 298, aff’d 28 NY2d 80; *Edsall v Wheeler*, 29 AD2d 622, 623; 10 McQuillin, *Municipal Corporations*, § 29.101; 40 NY Jur, *Municipal Corporations*, § 809).”)

21. Eleanor Randolph, *Robert Moses, Builder, Left Behind His Power Tool*, *New York Times*, February 14, 2007, p. A26.

But not all authorities have recurring and well-defined revenues. In the late 1960s the Rockefeller administration embraced the concept of “moral obligation” debt, whereby authorities issued bonds backed by unpredictable revenue streams accompanied by an unenforceable promise of the State Legislature to appropriate funds for debt service on the bonds, if necessary.²² Often, a lease with the State or a contract with a State agency was the only revenue source backing moral obligation bonds. As was said in *Schulz v. State*²³:

Essentially, moral obligation debt is created when the State, through legislation, directs a public authority or other public corporation to issue bonds as a means of financing various public capital improvement projects and then, through outright gift or via a variety of long-term, non recourse agreements or capital leases, provides it with the requisite income to secure the bonds and make debt service payments thereon. Because the bonds are secured only by the revenue streams from the agreements or leases and not by the full faith and credit of the State, *and under the terms of the leases or agreements the State has no legal obligation to appropriate money to make payments, it has no legal liability to the bondholders and effectively divests itself of all but a moral obligation to appropriate the moneys necessary to fund and secure the bonds.* (Emphasis added)

Moral obligation financing is also defined in the “Statement of Annual Information Updated Pursuant to Continuing Disclosure Agreements for Fiscal Year 2005-06” (“AIS”) published by the State on July 28, 2006, as follows²⁴:

Moral obligation financing generally involves the issuance of debt by a public authority to finance a revenue-producing project or other activity. The debt is secured by project revenues and includes statutory provisions requiring the State, *subject to appropriation by the Legislature*, to make up any deficiencies which

22. See generally Quirk and Wein, *Rockefeller’s Constitutional Sleight of Hand*, EMPIRE STATE REPORT, at 430, Nov. 1975; Tyler, *The Steady Growth of Backdoor Financing*, EMPIRE STATE REPORT, at 213, June 1975.

23. 193 A.D.2d 171, 174 n.1 (3d Dept. 1993), *aff’d* 84 N.Y.2d 931 (1994).

24. Statement of Annual Information Updated Pursuant to Continuing Disclosure Agreements for Fiscal Year 2005-06”, pg. B-13, July 28, 2006, available at <http://www.budget.state.ny.us/investor/finldisclosure/disclosuredocument0506.pdf>.

may occur in the issuer's debt service reserve fund...The State does not intend to increase statutory authorizations for moral obligation bond programs. (Emphasis added.)

To the extent Hudson Yards revenues are insufficient to meet HYIC debt service requirements, the HYIC financing fits the definition of moral obligation financing. Moral obligation debt, or, as it is sometimes referred to, "back door" debt, has become discredited, and on the State level in recent years there have been debt reform initiatives to discourage such borrowing.²⁵

In addition to the Schulz case, *supra*, the Court of Appeals has found moral obligation financing to be constitutional and legal. See, e.g., *Wein v. City*, 36 NY 2d 610.²⁶ The HYIC Official Statement is careful to emphasize that there can be no assurance that funds to pay annual debt service will be appropriated. The Official Statement emphasizes that the HYIC debt is not City debt. Despite the risks disclosed to bond buyers, the bonds received an excellent rating and were six times over-subscribed. The planned issuance of \$1.5 billion was increased to \$2 billion. The concern of the Committee, however, is that the primary risk in the financing was assumed by the City, rather than the bondholders, and that assumption carries significant long-term public policy implications.

III. CITY RISK

There are three essential elements to the risks the City has taken in its financing decisions with respect to the Hudson Yards Project.

1) Cost Overrun

The first element is the decision to finance 100 percent of the 2006 cost estimate of the Subway Extension. To govern is to choose, and one of the most exquisite choices of urban government is the allocation of its limited capital transportation funds. With respect to mass transit capital

25. *New York's Public Authorities: Promoting Accountability and Taming Debt*, Citizens Budget Commission, Sept. 5, 2006, available at <http://www.cbcny.org/Authorities%20Book%209-06.pdf>.

26. There is a limit, however, to the Court of Appeals' tolerance to what some may consider evasions of constitutional design with respect to municipal finance. The Court of Appeals held the City's note moratorium unconstitutional in *Flushing National Bank v. MAC*, 390 NY S2d 22, notwithstanding the confidence of the City and State lawyers at the time that police power considerations would trump the literal text of the State Constitution.

spending in the City, the fundamental decision makers are the State, the City, the MTA (a creature of the State), and the federal government. The federal government allocates substantial capital funds for the benefit of mass transit in the State. In the metropolitan region, these federal capital funds are applied for by the MTA. Funds accessed are required to be matched by the beneficiaries: State and local government. The MTA decided not to apply for federal capital funds for the Subway Extension. Other transit projects, such as the completion of the Second Avenue subway and the JFK Airport/Wall Street rail link were deemed to be higher priorities. But the City considered the Subway Extension of such critical importance that it decided to fund it 100 percent—at least to the extent of the 2006 cost estimate, *i.e.*, \$2.1 billion. In making this difficult choice, the City ruled out other possibly less expensive alternatives, including light rail and bus systems, without public debate.

It is beyond the expertise and scope of the Committee to assess the transportation economic correctness of the City's decision in terms of transportation economics, but the Committee can recognize the consequences of the decision. Transportation is the servant of economics. Yet in the Hudson Yards Project, the City intends to create the transportation to drive the economics so that the transportation has a dynamic to serve. Instead of responding to a demand, the City is attempting to create one. The cost is not static, and there is a substantial likelihood that the Subway Extension will cost more than \$2.1 billion. It has been reported that construction costs in New York City are increasing by about 1 percent a month. The cost estimate for the Subway Extension initially was formulated in 2004 at \$2 billion and revised in 2006 to \$2.1 billion. Recent reports, however, suggest that that amount is inadequate and that the actual cost could be in excess of \$3 billion. The new leadership of the MTA has stated publicly that it will not pay for any of this possible increase. (The costs of other MTA projects are rising also.)²⁷ The City is not committed to pay any cost overruns on the Subway Extension and runs the risk of having to do so or delaying its completion. If the Subway Extension were to be significantly delayed or discontinued, there might be a severe impact on the revenues that the Hudson Yards Project could generate. This possible dilemma could confront a future mayoral administration.

2) Revenue Shortfall

The second essential element of risk is that revenues will not be gen-

27. New York Times, February 14, 2007, p. B2

erated in the Hudson Yards Project area soon enough or in sufficient amount to service the bonds, *i.e.*, that the buildings generating the PILOTs will not be built. This risk is ameliorated by the fact that the HYIC bonds pay interest only for 40 years until their maturity.²⁸ The risk dramatizes the possible significance of the City's choice of moral obligation bonds as opposed to general obligation bonds.

For a variety of reasons development on the far west side may not proceed as planned, and very few of these reasons are in the control of the City. The City can combat but cannot necessarily prevent another catastrophic hostile attack, nor can it manage global economic events. So too, a future Mayor and City Council may be faced with unrelenting political pressures that force them to choose between revenue bondholders and other government imperatives. Development also may be impeded by rapidly rising costs, environmental problems, construction delay, labor stoppages, and adverse market conditions.

The government sponsored massive development of the far west side and its dependence on PILOT revenues bears an eerie resemblance to the development of Battery Park City in the early 1970s, in its time the largest urban development project in U.S. history.²⁹ Battery Park City was financed by moral obligation bonds, *i.e.*, the revenue bonds floated to finance the development were to be serviced by the ground rents the developers of the to-be-built substantial commercial and residential high-rise buildings were going to pay. Until construction was underway and the ground rents payable, the State legislature was morally obliged to appropriate debt service on the bonds. The buildings, however, did not get built on schedule. As a result Battery Park City Authority ("BPCA"), which had been created to issue the moral obligation bonds, was not able to pay the debt service. The City fiscal crisis of the 1970s (the "Fiscal Crisis") ensued because the capital markets abruptly closed to City debt, due in part to BPCA's dance with default.³⁰

The pain and continuing adverse consequences of the Fiscal Crisis and the closure of the capital markets to the City do not have to be

28. HYIC Official Statement (see Summary Statement).

29. See generally M. David Gelfand, *Seeking Local Government Financial Integrity Through Debt Ceilings, Tax Limitations, and Expenditure Limits: The New York City Fiscal Crisis, The Taxpayers' Revolt, and Beyond*, 63 MINN. L. REV. 545 (1978); see also Janice C. Griffith, "Moral Obligation" Bonds: *Illusion or Security?*, 8 URB. LAW. 54 (1976) (discussing moral obligation bonds in the context of the New York State Urban Development Corporation (UDC) bond default, a prelude to the Battery Park City crisis).

30. The fiscal crisis could more aptly be called the "financing crisis."

recounted. Because of this history, however, it is unlikely that a future mayor would let the HYIC revenue bonds default, even though a future mayor legally could do so, because the capital markets likely would consider the default a failure to pay by the City. Nevertheless, the risk of such a default exists, and the choice may have to be made. And even if a future Mayor were to decide to pay debt service on the HYIC bonds, a new City Council, with no connection to the current Council, might not agree, particularly if there were politically compelling needs that the Council members deemed more essential than the needs of bondholders, who knowingly took the risk of buying debt the City was not legally obligated to honor.

Deputy Mayor Doctoroff has stated in response to a query that, if the buildings were not to be built and there were insufficient revenues to pay the debt service on the HYIC bonds, the bonds could be renegotiated. That assumption may not be realistic; if renegotiation were to be viewed by the Capital Markets as the same as default, the collateral consequences would be unduly severe. It would be perilous to ignore the clear lesson of the Fiscal Crisis. It is the Committee's view that the Hudson Yards Project's financing plan presents issues of public policy risks in infrastructure financing that have not received a thorough public discussion especially if the Hudson Yards were to be a model for future development.

In substantial part, the Fiscal Crisis resulted from the City's reliance on borrowing rather than living within its means. For the Hudson Yards project, the City again may have overstepped its means. The City could have decided to live within its constitutional limits (or means) and employed general obligation debt to finance development of the far west side. That decision would have subjected the Hudson Yards Project to a greater scrutiny and a broader debate and forced choices among competing projects. Instead, the City devised a revenue bond alternative that accomplishes by indirection what the City may not have been able to accomplish by direction and avoided the need to make such choices. But in doing so, the City has embraced the risk of future difficult choices between HYIC default and the burden of paying HYIC debt service.

The City may also have set a troubling precedent by adopting a financing plan for HYIC that minimized opportunities for public debate and governmental approvals. Because the bonds were favorably received by the credit markets, this financing method may be used again for other large-scale projects which arguably should receive greater public scrutiny. It is also an undesirable precedent if continued resort to the PILOT method of finance erodes the City's real estate tax base.

The City's Hudson Yards Project financing decisions highlight a quandary that all governments must face. As the country simultaneously ages and grows, the demands placed on and for infrastructure grow as well. Existing infrastructure must be kept in good repair, and new, elaborate infrastructure must be installed. The costs are staggering, and they need to be financed; future generations rightly should pay for current infrastructure investments. Which infrastructure to maintain and build and how to finance these costs are critical questions, especially since such long term issues must be decided by short term political incumbents, particularly in the City where term limits prevail. Those who hold elective and appointive office today will not be in office in the figurative tomorrow when their decisions are manifested.

The bar, however, is not elected; it should take the long view. The Committee believes that the Hudson Yards Project financing raises issues germane to the larger, increasingly significant question of how infrastructure should be financed. The Committee further believes that it is in the interests and area of responsibility of the bar that it register its views on such questions, particularly as financing schemes are devised that are outside constitutionally proscribed methods. Financing infrastructure will require innovation. Over 30 years ago, however, the State began relying on then innovative conduit and moral obligation debt, and the City increasingly seems to be emulating the State's techniques.

3) Tax Subsidies; Financing Equals Policy

A third risk element of the HYIC financing is the extensive use of tax breaks and discounts offered to developers. The substantial discounts, which vary depending on the distance the new to-be-developed commercial property is in relation to the Subway Extension, obtain for 19 years. The annual rate of increase in the discounted PILOTs is equal to the lesser of 3 percent or the actual increase in assessed valuation of the property. Developers also are excused from paying sales tax liabilities they otherwise would incur in development. There is a substantial policy question whether subsidies to developers are required to induce investment on the far west side. If commercial and residential development on the west side is inevitable because it is the only logical place to which Manhattan's central business district can expand, why should costly artificial economic incentives be offered to encourage that development? There is an enormous risk/reward ratio in property development; it is not for the faint of heart. It is a proper function of government to control development and to provide incentives to assure certain kinds of development, *e.g.*, affordable hous-

ing. Zoning is the most effective tool for government to employ to put development in the context of sound planning. But government's broad use of financial incentives (a political choice), and their possible disruption of market forces, is more debatable.

The *Bond Buyer* recently paraphrased comments of City Office of Management and Budget Director Mark Page with respect to the tax breaks of the Hudson Yards Project:

Questioned as to why the city should give tax discounts to developers if the area was likely to be developed anyway, Page said developers in New York are accustomed to receiving tax breaks and felt entitled to them. The tax concessions in the area are average compared to incentives in other parts of the city and are designed to favor earlier developers and those who build farther from transportation.

Are tax breaks analogous to birthday gifts to be given on a regular basis whether or not deserved? Mr. Page offers a colorable rationale, but there is no documentation that development would not take place without the tax breaks. Mr. Page was speaking extemporaneously and did not have an opportunity to elaborate.

Tax breaks are not necessarily a panacea for economic growth. In May 2002 the Bloomberg administration awarded Pfizer \$46 million in tax breaks and subsidies "for the company's decision to expand in New York City and its promises to add net jobs to the City's economy."³¹ Four years later Pfizer announced it would close its Brooklyn manufacturing facility, eliminating about 600 jobs. At least 22% of companies that got tax breaks from the City in 2005 have cut their work forces according to a study released May 8, 2007 by New York Jobs with Justice. A recent New York Times article entitled "Are Tax Breaks for Builders Still Needed in Hot Market?"³² began:

The Bloomberg administration's recent move to re-evaluate the tax breaks used to encourage apartment construction in New York City has led to the beginnings of what will likely be an impassioned debate: In the hottest real estate market in decades, to what extent do developers still need tax incentives to entice

31. David Lombardo, *The Sun*, Pfizer Job Cuts May Mean Loss of Tax Breaks, January 23, 2007, page 1.

32. Janny Scott, *N.Y. Times*, March 16, 2006, Sec. B, Col. 1, Pg. 6.

them to build? In a report to be released today, New York Acorn, a community group, argues that the city's most popular tax-incentive program, known as 421-a, is not only generating much moderately priced housing in places like Downtown Brooklyn, but is, in effect, subsidizing a lot of expensive housing in gentrifying neighborhoods.

Senator Charles Schumer, chair of the civic organization The Group of 35, which issued a report calling for the City to develop new areas for office expansion, in a 2005 speech before the Partnership for the City of New York argued:

I do not believe we need to give developers tax breaks—the reduced PILOTS—to get them to the West Side. That money should be used for the building of the No. 7 line if needed. There is already growing developer interest in the area and I see no evidence that reductions in PILOT payments—“de facto tax breaks at the City's expense” are needed. Traditionally in this City, infrastructure alone is sufficient to induce development As far as I am concerned, the No. 7 line IS the subsidy for that development and West Side developers should pay “full fare”³³ (emphasis in original).

One explanation why the PILOT subsidies are being so extensively used in the HYIC financing plan is that they are necessary to ensure that development on the scale required occurs and that PILOT revenues are generated to pay for the infrastructure and its financing. As discussed *supra*, the risks of the financing failing are untenable. The need to grant the subsidies could have been avoided if the financing method selected had been general obligation debt. If that alternative had been chosen and approved, PILOTs would not have been necessary, the properties would have remained on the tax rolls, and non-discounted real estate tax revenues would have flowed to the City's general fund.

In addition to setting the precedents of diverting PILOTs and granting generous tax subsidies to developers, which will encourage the expectation of similar subsidies in future projects, the diversion and diminu-

33. See, Testimony of James A. Parrott, PhD., Deputy Director and Chief Economist, Fiscal Policy Institute, Hearing before New York City Industrial Development Agency (“Proposal to Amend the Uniform Tax Exemption Policy for Hudson Yards Commercial Construction Projects”) New York City, August 3, 2006. Dr. Parrott warned that fights may develop in the City over whom is entitled to a tax break.

tion of the PILOTs raises a much broader question of fundamental fairness. In effect, by diverting PILOTs to specific revenue bonds, the taxpayers of the City are subsidizing developers and the buyers of the HYIC bonds. Of course, if the Hudson Yards Project were to be a success, it should generate much more benefit (including enhanced income tax revenues) than its cost. The HYIC financing plan is predicated upon an analysis by Cushman & Wakefield, Inc. of the potential revenues from development in the Hudson Yards Project area. Based on the assumptions of timely completion of the Subway Extension and sustained development activity, the Cushman & Wakefield study finds that estimates by the City, that revenues expected to be received by HYIC from projected new office, residential, hotel and retail development could aggregate between \$35 billion and \$39 billion during the period ending 2050, are reasonable. During this period HYIC's financing costs could be \$10 billion.

Early development activity at the Hudson Yards indicates that the Cushman & Wakefield analysis may be valid. As of April 30, 2007 the President of the Hudson Yards Development Corporation has reported that "There's a lot of housing going forward now". Also, the HYIC has received \$20 million of district improvement fund bonus payments (See footnote 6.) according to HYIC President Alan Anders.³⁴ There also are reports that 20 projects are either proposed or in progress that would include at least 570 condominiums, 5, 228 rental units, 5 hotels and 4 commercial buildings.³⁵

However, if projects proposed do not progress and if the Hudson Yards Project were not to be successful on the assumed time table, just as Battery Park City was not successful for many years, there will not be revenues to pay for basic City services on the far west side generated from the far west side because the property tax revenue would have been diverted from other City uses to pay debt service. The City Council may be called upon to appropriate additional City funds to pay the debt service well beyond the early development years. Such an appropriation would divert public funds to debt service from other City services to the detriment of citizens relying on such services. The political difficulties of making appropriations for debt service in such a situation would be heightened for the City Council by the pressure of the credit markets to avoid a default on bond payments with its attendant negative market consequences.

These possibilities reflect another lesson of the Fiscal Crisis, namely,

34. The *Bond Buyer*, "Progress at Hudson Yards", April 30, 2007.

35. *Ibid.*

that at its height, every decision the City made was in the context of regaining access to the credit markets. Policy determination was geared to financing imperatives. Financing was policy, rather than a means of implementing policy. During the Fiscal Crisis, that was a regrettable but necessary distortion of governing. It is not necessary now. Yet, in many respects, the subsidy policies of the Hudson Yards Project are dictated by the financing choices. The Committee believes that this skewing of policy choices to enable the selected financing method should be subjected to close scrutiny.

With appreciation of the difficult infrastructure financing demands that confront public officials and with recognition of the need of such officials to make hard choices in the near term, the Committee hopes that its Report will contribute to a necessary dialogue about financing infrastructure expansion in New York.

May 2007

Committee on New York City Affairs

Peter J. Kiernan, *Chair*

Avitai Gold, *Secretary*

A. Rebecca Adams	Daniel C. McElhinney
Sean Basinski	Steven L. Nemetz
Daniel R. Bright	Russell Ann Nobles
James Y. Chin	Leah J. Griggs Pauly
David M. Curcio	Blossom Audrey Peretz
Nicholas Diamand	Dana L. Post
Timothy C. Doherty, Jr.	Elaine S. Reiss
Thomas A. Dunne	Jordan M. Rosenbaum
Robin Hope Gise	Shirley Adelson Siegel
Jennifer Beth Handler	Jordan Stern
Eric Hecker	William B. Stock
Johnathan Hollis	James Stewart Strauss
Frederick M. Joseph	William C. Viets
Thomas R. Lamia	Michael Sean Weinstock
Charles F. McCormick	